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# Bond Insurers Evaluate Business Prospects Amid Investor Uncertainty As RMBS Shakeout Continues

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# Bond Insurers Evaluate Business Prospects Amid Investor Uncertainty As RMBS Shakeout Continues

The bond insurance industry's exposure to 2005–2007 vintage direct and indirect residential mortgage-backed securities (RMBS) transactions will continue to weigh on bond insurers for many years, and its ramifications will be far-reaching, affecting both the role of existing and new participants and the mix and magnitude of business that they will underwrite. This is the assessment of Standard & Poor's Ratings Services, which has been tracking closely the progression of this credit event and running a series of evolving stress test scenarios since March 2007.

For most insurers, we have witnessed a significant decline in business opportunity as investor appetite has dwindled as a result of these companies' financial difficulties. The presence of meaningful nonprime mortgage exposure has led to forced "hibernation" for some insurers, while others have commuted credit default swap contracts in exchange for cash and ownership interests in order to survive.

We believe some companies have responded in a timely and comprehensive way to the need for greater capitalization that our stress testing has identified, although they will face diminished new business in public finance and structured finance and declining financial flexibility. Other companies have not been able to respond as effectively as needed, and their franchises have been significantly impaired due to scaled-back underwriting activity and concerns about their ability to address prospective capital needs. Meanwhile, potential competition from new entrants pose an additional threat.

For all companies, we believe continuing deterioration in key areas of the U.S. residential mortgage sector and related collateral debt obligations of asset-backed securities (CDO of ABS) structures will continue to place pressure on capital adequacy. Table 1 lists Standard & Poor's current ratings on the financial guarantors.

**Table 1**

Insurer Ratings	
<b>Primary Insurers</b>	
ACA Financial Guaranty Corp.	CCC/Watch Dev
Ambac Assurance Corp.	AA/Negative
Assured Guaranty Corp.	AAA/Stable
Berkshire Hathaway Assurance Corp.	AAA/Stable
CIFG Assurance North America, Inc	B/Watch Dev
Financial Guaranty Insurance Co.	BB/Watch Neg
Financial Security Assurance Inc.	AAA/Negative
MBIA Insurance Corp.	AA/Negative
Radian Asset Assurance Inc.	BBB+/Negative
Syncora Guarantee Inc.	BBB-/Watch Neg
<b>Reinsurers</b>	
Assured Guaranty Re Ltd.	AA/Stable
BluePoint Re Ltd.	R
Channel Reinsurance Ltd.	AA/Negative

**Table 1**

<b>Insurer Ratings(cont.)</b>	
RAM Reinsurance Co Ltd.	AA/Negative
Syncora Guarantee Re Ltd.	BBB-/Watch Neg

'R' rating indicates company is under regulatory supervision because of its financial condition.

## **An Impaired Industry With Uncertain Prospects**

In our view, the bond insurance industry has been significantly impaired by the impact of actual losses paid and reserves set aside for bond insurers' exposure to 2005-2007 vintage direct and indirect RMBS transactions. Heightened investor concerns stemming from headlines proclaiming a wide range of loss assumptions for this exposure have shaken confidence in the sector. We won't know the full extent of structured finance losses for some time, but they will affect the capital and financial flexibility of the insurers because many have already exhausted most of their near-term capital raising opportunities or because the cost of raising capital has become too expensive.

New business prospects for the current insurers as well as new entrants are uncertain given that, while the U.S. public finance new-issue market is active, the insured penetration rate is significantly reduced -- and is likely to remain so for the next several years -- and the structured finance business for the insurers is dormant.

For the eight months ended Aug. 31, 2008, the U.S. public finance primary market insured penetration rate fell 49 percentage points from a year earlier, to 21%. However, the penetration rate for the enhancement that bank letters of credit (LOCs) provide is up 3 1/2 times, to 18%. The use of LOCs has somewhat replaced financial guarantee policies, with the greatest impact occurring in the transportation sector. This sector historically has one of the higher insured penetration rates, and total new issue volume was up 55% in the first eight months of 2008. Issuers, however, have used LOCs to provide enhancement of auction-rate securities, for which issuance volume is up significantly, in place of financial guarantee insurance. The high volume is likely unsustainable, as LOC pricing has increased due to banks' much-higher cost of capital.

Sector issuance volume may also have influenced the decline in insurance penetration. For example, the education sector experienced a 13% decline in total new-issue volume in the first eight months of 2008, and it, too, is one of the sectors with a historically high insured penetration rate.

Finally, with Financial Security Assurance Inc. (FSA) and Assured Guaranty Corp. (AGC) being the only insurers writing significant business volume in the first half of the year, these companies' own restraint in par insured production may have had a limiting effect on the insured penetration rate. Within the secondary market, however, the 'AAA' rated bond insurers issuing policies were able to capitalize on market volatility and reported a significant increase in volume.

While the various CDO of ABS commutation strategies that have been undertaken or are being considered may bring clarity to cash payouts and perhaps enhance a company's capital position, some in the market are interpreting them as a possible gauge of an insurer's future willingness to honor financial guarantees. In some instances, an insurer may be settling a credit default swap for something less than the current mark-to-market derived estimate of loss while the ultimate loss on the insured exposure remains uncertain. The counterparty, however, may have other interests, economic, financial, or business, that play into its strategy to commute a contract. While some insurers have improved their financial position using commutation, questions have been raised about whether this could

harm their future competitive positions because of investor concern regarding future claims payment strategies.

## Nonprime RMBS Stress Test

Standard & Poor's tested the capital adequacy of the bond insurers and reinsurers against scenarios that apply stressful default assumptions to various insured RMBS-related transactions. The various stress tests that we have conducted since March 2007 have widened over time to include the 2005-2007 vintages and deepened to include progressively larger cumulative net loss assumptions for insured direct RMBS and CDO of ABS that include tranches of uninsured RMBS. We based the default rates for these transactions on stressful cumulative net loss assumptions, which Standard & Poor's Structured Finance department supplied, that vary by asset type and vintage. We have included the Alt-A, subprime, closed-end second, home equity line of credit (HELOC), and net interest margin (NIM) asset types (see table 2).

**Table 2**

Asset Class Cumulative Net Loss Assumptions (%)					
Vintage	Alt-A	Subprime	Closed-End Second	HELOC	NIM
<b>Dec. 2007</b>					
2005	2.75	5.75	17.25	10.35	5.75
2006	3.50	15.50	40.00	15.75	15.50
2007	3.50	17.00	40.00	13.00	17.00
<b>Aug. 2008</b>					
2005	2.75	10.50	22.82	6.93	10.50
2006	7.10	23.00	50.24	22.62	23.00
2007	10.23	23.00	60.76	37.89	23.00

Source: Standard & Poor's Structured Finance department

To determine a company's capital adequacy, we combined the sum of the losses that the stress test on the 2005–2007 vintage RMBS transactions generated for each company with the modeled theoretical losses of the company's public finance book of business and that portion of the structured finance book of business not experiencing stress. We then used total losses from both stress tests to compute a margin of safety by dividing the ending capital plus theoretical losses by the theoretical losses incurred.

For 'AAA' rated insurers, the minimum margin of safety is 1.25x. For 'AA' and 'A' rated insurers, the minimums are 1.0x and 0.8x, respectively. Although the margins of safety are reported for year-end 2007, adjustments for subsequent capital raising activity and commutation of risk in 2008 were included.

Should the stress test losses on the 2005–2007 vintage RMBS book of business materialize, we would not necessarily view this as a liquidity crisis. Claims, if and when they occur, won't happen overnight. The majority of theoretical losses are back-ended and would likely be paid out over several years. As for swap exposure, there are no collateral posting requirements and swaps are generally written in a pay-as-you-go format.

Against the fundamental industry principle of paying principal and interest as due, most of the industry has relatively substantial liquidity. Usually more than 90% of balance sheet assets are fixed-income investments with weighted average ratings in the 'AA' category. Due to their quality, the investment portfolios generally lend themselves to reverse-repurchase borrowing if necessary.

Furthermore, the financial guarantors have significant built-in structural strengths, control of remedies, and active remediation that have been important to mitigation of loss. Nevertheless, for a few companies (Ambac Assurance Corp., MBIA Insurance Corp., and FSA) with guaranteed investment contract or investment agreement affiliates, substantive downgrades, were they to occur, could trigger termination provisions that might pressure these companies. All three companies, however, are taking steps to mitigate this risk.

## Changing Faces Of Market Participants

Although we view the industry as being impaired and recent events as presenting significant impediments to conducting new business, there continues to be demand for credit enhancement products from financially sound guarantors in the public finance and project finance markets. Within the U.S. public finance market, while insured volume is off in general, it remains the focus of guarantors' underwriting strategies. Many more issuers are going to market without insurance, and we expect reduced insured volume for some time.

However, the recent growth in the use of bank LOCs and other financial guarantee alternatives provides some evidence that investors continue to demonstrate demand for some type of credit enhancement. In the U.S. public finance segment, pricing has remained strong due to the lack of competition. However, a shrinking municipal market, combined with the entry of new competitors, may pressure pricing.

In our opinion, the current financial guarantors are in three categories:

- Those generally unaffected by the current RMBS stress;
- Those impaired to a moderate degree by the current situation; and
- Those seriously damaged by the current situation.

AGC is the only active primary insurer with a AAA/Stable rating from Standard & Poor's, given that current conditions have not generally affected it. Ambac, FSA, and MBIA have all been impaired to a moderate degree, with FSA, in our view, the least affected of the three. FSA retains a 'AAA' rating but with a negative outlook and has announced that it is exiting the structured finance business. We believe the move aligns FSA's business model with that of its owner Dexia S.A., heavily emphasizing European (and U.S.) public finance and project finance.

Ambac and MBIA have each announced plans to launch a new subsidiary focused on U.S. public finance and to restructure their respective operating company to capitalize on business opportunities in the market. Those companies that are seriously damaged and whose ratings we've downgraded significantly, have uncertain outlooks, and questionable capital adequacy include Financial Guaranty Insurance Co., Syncora Guaranty Inc., the CFIG Cos., ACA Financial Guaranty Corp., and Radian Asset Assurance Inc.

Not surprisingly, this recent adversity has triggered interest among outsiders in entering the financial guaranty space. Prospective new entrants to the market range from traditional financial guarantors to nontraditional enhancement providers, such as state pension funds, government-sponsored enterprises, and derivative product companies. The relatively short list of potential new competitors in the financial guaranty business includes Ambac's and MBIA's proposed companies.

Our ultimate view of these start-ups will depend in large part on whether we believe management can put together a sustainable business model and demonstrate the ability to generate a profitable stream of revenue that is of sufficient volume and quality to support the capital employed in the business. Furthermore, we believe strong enterprise risk

management capabilities will be critical to achieving high credit ratings.

A new company would face several substantive challenges. One of the biggest ones would be to assemble a top-notch management team. Only a finite number of seasoned executives have the requisite experience to take on the senior management responsibility of a bond insurer. Another hurdle that new companies would face, notwithstanding the need for insurer diversity, is the fact that the trading value of their insured bonds may be lower than that of the established companies. This may translate into a need to charge a lower premium in order to provide the same benefit to the issuer, a tactic that could diminish the company's profitability.

For financial guarantors looking to form new insurance subsidiaries or affiliates concentrated on U.S. public finance business, a key question is whether it will be possible to have disparately rated entities under the same holding company structure. One possible solution may be to effectively wall off or insulate the new subsidiary from the risks of the existing operating company. While meeting rating agency criteria for ring fencing the risk of an existing insurance operation, management may also need to address market concerns about the remoteness of affiliate risk to the new company. After all, if the market does not view the corporate structure as sound, that may call into question the viability of the new insurance operation.

Much of the discussion in the press in the spring about state pension funds or government-sponsored enterprises as possible providers of credit enhancement has now faded. Derivative product companies (DPCs) have quietly grown in numbers over the past few years and have emerged as a possible alternative to the financial guarantors. Their business focus, however, has been on single-name obligors, such as corporations and asset-backed securities, or on tranching structured finance obligations, with execution in the form of credit default swaps. Enhancing municipal obligations has occurred on a very limited basis, with only a handful of rated DPCs selectively participating in transactions that specifically meet their eligibility criteria, as mandated by their operating guidelines. It is not expected that DPCs will become significant players in the municipal market.

## **Can The Industry Regain Credibility?**

The financial guaranty industry may compress at the same time that the financial guarantors reorganize themselves, seek to further bolster their capital levels, and make changes to their business models. We believe for those insurers with weakened franchises and that are pursuing new business strategies, regaining their former credibility with clients and investors will be difficult. Not too long ago it became evident that a return to a municipal-dominant business model seemed likely as the insurers' risk appetites diminished. This shift is already taking place as investors and regulators have now made clear their desire for highly rated and municipally-focused bond insurers. We believe there may be increased demand for bond insurance in the future but that it will take time and will depend on the insurers' capital strength and ability to achieve stable high-grade ratings. We expect that investors will continue to favor insurers that are able to demonstrate sound surveillance and remediation capabilities, bondholder representation, and other risk management capabilities.

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